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In the Supreme Court of the United States

October Term, 1949

No. 453

Joe Shoong,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.

and

Rose Shoong,
Petitioner,
vs.
Commissioner of Internal Revenue,
Respondent.

CONSOLIDATED BRIEF FOR PETITIONERS.

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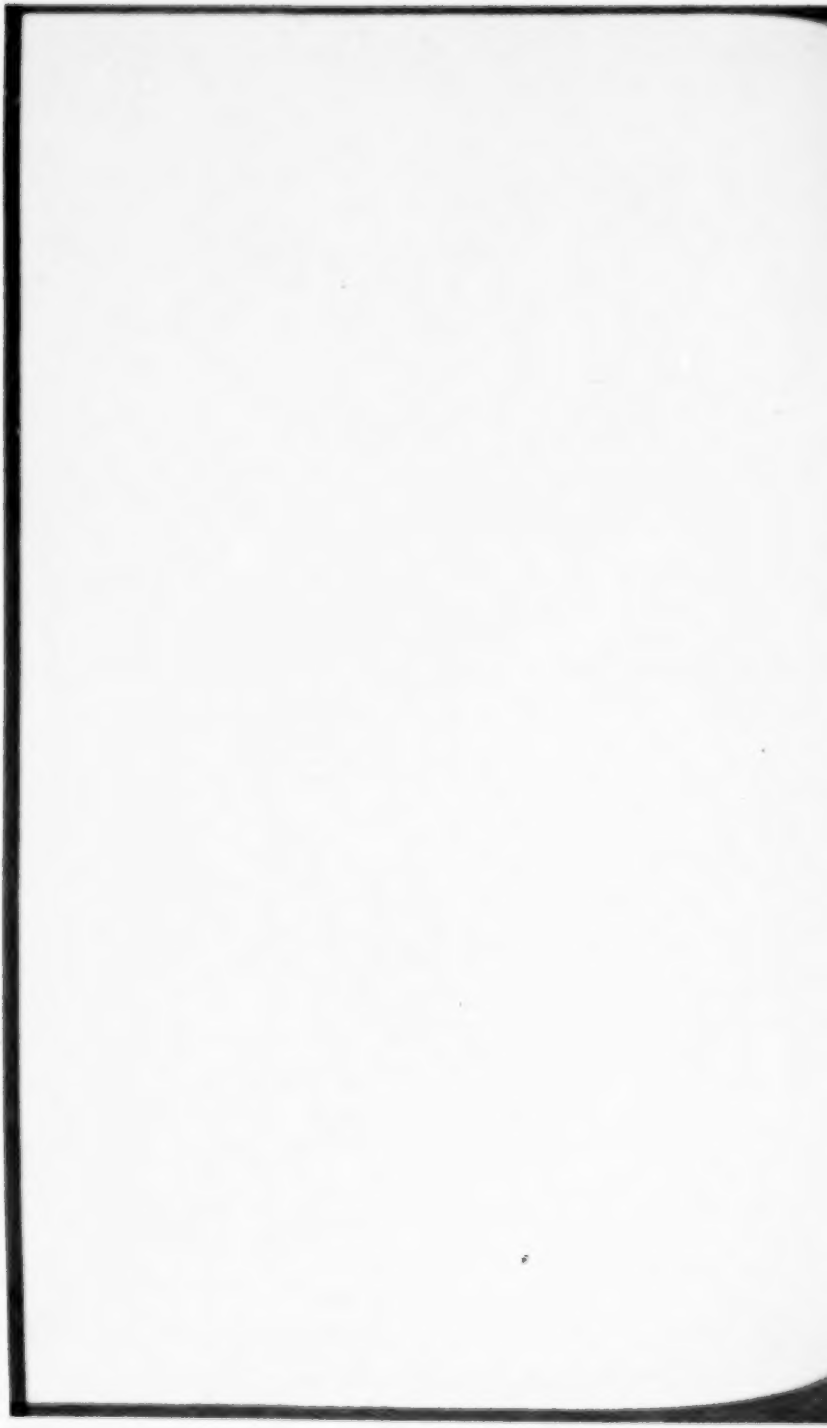

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CONSOLIDATED BRIEF FOR PETITIONERS.

PREPATORY STATEMENT.

The following brief was prepared in anticipation of the granting of the petition for a writ of certiorari. Upon being advised by the Solicitor General on January 23, 1950, that the Court was likely to defer the preliminary

ruling on the petition in this case until after the Court had decided *Commissioner v. Korell*, Number 384, counsel for petitioners in this case on January 24, 1950, sent the following telegraphic message to the Clerk of the Court:

> "We have been awaiting ruling in Shoong versus Commissioner Number Four Five Three We are advised Korell case Number Three Eight Four involving substantially identical issues scheduled for hearing February Seventh We suggested to Solicitor General that argument in Korell case be postponed until after Court rules on Shoong petition and thereupon if petition be granted that hearing in both cases be set for argument together as requested by Solicitor General in respondent's memorandum filed in Shoong case Solicitor General now informs us that Court will proceed with argument in Korell case and defer ruling in Shoong case until Korell case disposed of Assuming this report to be correct are we right in interpreting the Solicitor General's report as meaning that only if Korell judgment is affirmed will the Court grant Shoong petition Does it also mean that if Korell judgment is reversed Court will ipso facto deny Shoong petition We respectfully request you to convey this inquiry to the Honorable Chief Justice indicating our understanding that if Korell case be reversed and Shoong petition be denied it will foreclose Shoong petitioners from presenting important comprehensive supplementary brief containing additional arguments and authorities as well as reference to evidence in record not included in original petition and brief This supplementary brief now ready for printing We believe this brief will be helpful to Court Furthermore as we interpret Solicitor General's report Shoong petitioners may be denied opportunity to be heard on oral argument

Please convey to the Honorable Chief Justice desire of Shoong petitioners to be heard on merits especially applicable to their case and that Court rule currently on Shoong petition so that both cases may be heard together as requested by Solicitor General If the Honorable Chief Justice authorizes response to this inquiry please telegraph charges collect We are sending copy of this telegram to Solicitor General via airmail"

To the foregoing message counsel received on January 25, 1950, the following reply from the Clerk:

"Do not consider it appropriate for me to speak to the Chief Justice in re matters referred to in Shoong case. For your information petition has been submitted to and considered by the entire Court PD it is not unlikely that action on the petition will be withheld until after argument in Korell case. Latter case will be argued week of February 6th. Any additional papers or motions you wish to submit in Shoong case will be received.

Charles Elmore Cropley Clerk"

In reliance upon the advice contained in the foregoing reply the accompanying brief is being served and filed on behalf of the petitioners, reserving such rights as the petitioners may have to file an additional brief or briefs in the light of subsequent events which may occur both in *Commissioner v. Korell,* Number 384 and in this case.

We respectfully request that this brief be also considered as an amicus curiae brief in *Commissioner v. Korell.*

I.

A. OPINIONS OF THE COURTS BELOW.

The Tax Court opinion is set forth in 7 T.C.M. 367 (Dec. 16453 (M)) and also appears in the record. (R. 31-9.) The opinion of the Court of Appeals appears in the record (R. 60 *et seq.*) and is reported at 177 F. (2d) 131.

The Tax Court opinion in *In re Korell* is reported in 10 T.C. 1001, while the initial opinion as well as the opinion on rehearing of *Commissioner v. Korell* is reported in 176 F. (2d) 152 (CCA 2).

B. JURISDICTION.

A. Statutory Provisions.

This Court has jurisdiction to review the Judgment in question, under Section 1254 of the Judicial Code (Judicial Code and Judiciary, Chapter 646—Public Law 773, Title 28, United States Code Judiciary and Judicial Procedure), which provides in Subdivision 1 thereof that cases in the Court of Appeals may be reviewed by the Supreme Court by Writ of Certiorari granted upon the petition of any party to any civil case after the rendition of judgment or decree.

It is further provided under Section 1141 (a), Internal Revenue Code (Title 26, USCA, 53 Stat. 164, amended October 21, 1942, 56 Stat. 957, and the amendment of June 25, 1948, C. 646, Section 36, 62 Stat. 991), that the judgment of any Court of Appeals reviewing a decision of the Tax Court, shall in turn be subject to review "by the Supreme Court of the United States upon certiorari in

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the manner provided in Section 1254 of Title 28 of the United States Code."

B. Rule of Court.

It is also provided under Subdivision 5(b) of Rule 38 of the Revised Rules of the Supreme Court that among the reasons which will be considered for the granting of a review on Writ of Certiorari is where one Court of Appeals has rendered a decision in conflict with the decision of another Court of Appeals on the same matter. (Revised Rules, Supreme Court, 28 USCA, Rule 38, Subdivision 5; *Commissioner v. Wodehouse*, 93 L. Ed. Adv. Ops. 1043, 1060; *Deputy v. DuPont*, 308 U.S. 488, 490, 500, 60 S. Ct. 363, 84 L. Ed. 416; *Helvering v. Northwest Steel Mills*, 311 U.S. 46, 61 S. Ct. 109, 85 L. Ed. 29.)

C. QUESTIONS PRESENTED.

1. Does Section 125 of the Tax Statute authorize the amortization of bond premium when bonds are callable and convertible?

2. Is the right to amortize bond premium on callable and convertible bonds supported by the basic legislative intent and history of the Tax Statute?

3. Do the Treasury Regulations recognize the right to amortize bond premium paid for convertible and callable bonds?

4. Does Section 125 of the Tax Statute set forth the precise rule for determining the existence of bond premium and the amount thereof?

5. Have the taxpayers discharged their duty of showing that they come clearly within the terms of Section 125 of the Tax Statute, and therefore are entitled to the deduction allowed therein?

6. Has the Court of Appeals accepted the statutory definition or even the common meaning of the terms "bond premium" and "amortizable bond premium"?

7. Is the bond premium of any bond purchased in the open market ever determined by the interest factor alone?

8. Has Congress or the Treasury Regulations under the authority of Congress established any method or standard for segregating the various factors which influence bond premium, and for evaluating each such factor?

9. Is the Commissioner's concept of a "true" amortizable bond premium, viz. resulting from the interest factor alone, based upon a fiction?

10. Is the Commissioner justified in imposing upon taxpayers an esoteric concept of bond premium and interest, resulting from abstruse and subtle analysis?

11. Did the decision of the Tax Court have warrant in the record and reasonable basis in the law?

12. If the question of amortization of bond premium is primarily an accounting problem, must not the decision of the Tax Court be accepted as final by courts of appeal?

13. Is it possible to determine administratively the amount of "bond premium" attributable to the interest factor alone, when the market price of the bond fluctuates

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sometimes during a single day and often from day to day?

14. Is the deduction for amortizable bond premium in the nature of an arbitrary allowance based upon the impossibility of determining administratively for each taxpayer with respect to each bond the amount of bond premium attributable to interest alone?

15. Is the result "unreasonable" or "garish" simply because unjust or unequal results sometimes occur when a statutory rule of thumb is applied by Congress without a detailed examination into the special facts of each case?

16. Does the decision of the Tax Court or the Court of Appeals make for uniformity of treatment?

17. Does the decision of the Tax Court or the Court of Appeals eliminate the confusion that is apt to arise from an attempt to determine for each taxpayer as to each bond what portion, if any, of the bond premium he is authorized to amortize?

18. Has the Court of Appeals engaged in a judicial attempt to remodel legislation?

19. Has the Court of Appeals trespassed beyond the judicial and upon the legislative process?

20. Are the courts permitted, in effect, to superimpose their own idea of legislative policy (through the guise of the judicial function) upon legislative intent when already clearly expressed by Congress, even though a specific court, or some of its members, may believe that the operation of a specific statute produces an "unreasonable" result, that is also characterized as "garish"?

21. Is not Congress the only agency that can correct inequalities, if any, created by Congressional legislation?

22. Are the income tax laws evaded when a taxpayer makes his purchases and sales of securities with the existence and application of prevailing tax laws in mind?

D. STATUTE AND REGULATIONS INVOLVED.

The provisions of the Internal Revenue Code and Treasury Regulations involved are set forth in the appendix hereto.

E. STATEMENT OF THE CASE.

This consolidated brief concerns alleged deficiencies asserted by the Commissioner of Internal Revenue (hereinafter, for purposes of brevity, referred to merely as "Commissioner") in respect to the petitioners' personal income taxes for the year 1944.

While there are two separate cases affecting the petitioners, respectively, they were consolidated both in the Tax Court (R. 20) and in the Court of Appeals (R. 52) for briefing, hearing, argument and decision.

The amount in controversy in the case of Joe Shoong is $58,441.99 (R. 8) and in the case of Rose Shoong it is $61,841.00. (R. 16, 18.) These amounts were originally determined by the Commissioner to be deficiencies against the petitioners. On review the Tax Court ruled favorably to the petitioners. (R. 31.) The Court of Appeals has reversed the ruling of the Tax Court. (R. 72.)

The question involved is whether the taxpayers could or could not take as a deduction in computing their 1944 net taxable income the amortization of premiums paid by them in the purchase in 1944 of American Telephone and Telegraph Company, fifteen-year, three per cent, convertible debenture bonds dated September 1, 1941, and due September 1, 1956.

The Commissioner and the Court of Appeals declared that the taxpayers could not take the deduction. The Tax Court declared that the taxpayers could take the deduction.

The facts are for the most part set forth in a Stipulation received in evidence before the Tax Court as "Exhibit A-1." (R. 20.) The following short statement embraces all the pertinent facts.

The petitioners are husband and wife, and reside in Oakland, California. They filed separate returns for the calendar year 1944 with the Collector of Internal Revenue for the First District of California on a community property basis. (R. 20-21.)

With respect to Joe Shoong, the record discloses that on June 21, 1944, he purchased bonds at a total cost of $606,541.66, which included the cost of the bonds, the commission and the accrued interest thereon. (R. 21.) In his income tax return for 1944, he reported adjusted gross income of $104,304.58 and deductions of $97,533.76, which latter amount included a claim of $81,879.94 for amortization of bond premium and accordingly he reported a net income of $6,770.82. (R. 21.)

With respect to Rose Shoong, the record shows that she purchased on June 26th and 27th, 1944, bonds for the aggregate amount of $610,501.67, which included the principal amount thereof at cost, plus the commission and accrued interest. In her income tax return for 1944 she reported adjusted gross income of $100,927.43 and deductions of $96,325.84, which latter figure included a claim of $85,607.29 as amortization of bond premium, and reported a net income of $4,691.59. (R. 22.)

The bonds were issued under an indenture, a copy of which is in the record (R. 23), and it appears therefrom that the bonds were convertible into capital stock of the issuing company at any time after January 1, 1942, and before January 1, 1954, at the conversion price of $140.00 per share, subject to certain adjustments. (R. 21.)

The terms of conversion of the bonds were stated as follows (R. 54, "Exhibit H"):

> "Terms of Conversion of Debenture Bonds into Capital Stock
>
> "At any time after January 1, 1942 but not later than December 31, 1954, unless previously called for redemption, the debenture bonds will be convertible into capital stock of the company. The conversion price will be $140 per share, payable by surrender of $100 principal amount of debenture bonds and payment to the company of $40 in cash for each share of capital stock to be issued upon conversion. The conversion price, the number of shares issuable upon conversion and the amount of cash per share payable upon conversion will be subject to adjustment as provided in the indenture.

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"Surrender of debenture bonds (with unmatured coupons attached) for conversion and payment of cash required upon the conversion is to be made at the office of the treasurer of the company, 195 Broadway, New York, N.Y."

The company's option to redeem the bonds in question was expressed as follows (R. 54—"Exhibit H"):

The company had the option to redeem all or from time to time any part of the redemption bonds on or after September 1, 1942, at the following redemption prices (expressed in percentage of the principal amount), together with accrued interest to the date of redemption ("Exhibit H" pages 28-29):

To and including August 31, 1944, 107%;

Thereafter to and including August 31, 1948, 104%;

Thereafter to and including August 31, 1953, 102%;

Thereafter, 100%.

Notice of the exercise of the right to redeem the bonds was required to be published at least four times, the first publication to be not less than thirty days and not more than ninety days before the date fixed for redemption. (R. 54—"Exhibit H.")

The entire issue of the bonds was called for redemption under the provisions of the bond indenture for payment on September 1, 1947, at 104% plus interest. (R. 23.)

The bonds purchased by Joe Shoong and Rose Shoong were not part of their stock in trade, or includable in any inventory of theirs at the close of the taxable year, or

held by them primarily for sale to customers in the ordinary course of their trade or business. They did not, during the calendar year 1944, sell any of the bonds purchased by them, nor did they exercise their privilege of converting said bonds into the capital stock of the company. (R. 28-29.)

In the deficiency notices which were sent to the petitioners by the Commissioner, he advised each of them that the deductions which each claimed for amortization of bond premium were disallowed "since it is held that the amount does not represent amortizable bond premium." He further declared "that the consideration represents the value of the right to convert the bonds into capital stock of the company." (R. 9, 18, 29, 30.)

Thereafter, both Joe Shoong and Rose Shoong filed their petitions before the Tax Court for a re-determination of the deficiency set forth by the Commissioner in his notices of deficiency (R. 4, 12), and in due course the Tax Court made its Memorandum of Findings of Fact and Opinion (R. 31) and rendered its decision favorable to the petitioners. (R. 37.)

Thereafter, the Commissioner filed his petition for review with the Court of Appeals (R. 39, 43) to review the decision entered by the Tax Court, and thereafter the Court of Appeals disposed of the matter as hereinbefore set forth.

F. SPECIFICATION OF ERRORS.

The Court of Appeals erred:

1. In holding that the purchase price paid above par for the bonds was paid solely for the stock purchase covenant.

2. In finding that Congress did not intend that the amount paid for the bonds over par should be the premium designated as "amortizable bond premium."

3. In finding that the amortizable bond premium which Congress intended as an allowable tax deduction is that part of the premium or purchase price paid above the bond par value which arises from the interest return alone.

4. In deciding that the amortizable bond premium for which a tax deduction is provided in the tax statute is not the premium paid in part for the convertible feature of the bond.

5. In basing its determination of congressional intent with respect to the tax statute upon the profit derived by the taxpayer from his investment.

6. In holding that the tax statute does not define "amortizable bond premium," when Section 125 (b) (1) provides that the "amount of bond premium" shall be determined with reference to the cost and the "amount payable on maturity or on an earlier call date," and Section 125 (b) (2) provides that "the amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year."

7. In finding that the meaning of the phrase "amortizable bond premium" must be ascertained not only from a consideration of Section 125 as a whole, but also in connection with the Report of the Congressional Committee concerning the purpose of the legislation, although the language of that section plainly and unequivocally provides that bonds of the character involved in this proceeding purchased at a premium may be amortized.

8. In construing the statement of the tax adviser to the Secretary of the Treasury with respect to amortization of bond premium as being limited only to that portion of bond premium attributable to the interest factor alone.

9. In finding that the amount of the interest played no part in determining the purchase price of the bonds above par.

10. In finding that the definition of a bond in the tax statute limits the amortization of bond premium to the interest factor alone.

11. In excluding from the definition of bond (section 125 (d)) interest bearing bonds of the character here involved.

12. In holding that the provision for amortization of bond premium grants a deduction for capital loss on a bond inconsistent with all the other provisions of Section 23 of the tax statute.

13. In finding that its own interpretation of the phrase "amortizable bond premium" is reasonable.

14. In disregarding and invalidating Treasury Regulations 111, Section 29.125-5 which not only include con-

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vertible and callable bonds but specifically provide that "a convertible bond is within the scope of Section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof."

15. In holding inferentially that the amount of amortizable bond premium must be computed in some undisclosed and unstandardized manner not specifically prescribed in the statute or Treasury Regulations.

16. In misconstruing the language contained in the Ways and Means Committee's Report that convertible bonds are entitled to the benefit of the "amortizable bond premium" of the tax statute.

17. In finding that the stock purchase option contained in the bond could be exercised by the bondholder at once, when, in fact, the bonds were issued under an indenture dated September 1, 1941, which provided that unless previously called for redemption, the option could be exercised only after January 1, 1942, and between that date and December 31, 1954. (R. 23.)

18. In superimposing its own idea of legislative policy through the guise of judicial process.

19. In creating rather than finding doubts with respect to the scope and meaning of the statutes involved and then resolving those doubts against the petitioners, as taxpayers, when such doubts, if any, should be resolved in their favor.

G. SUMMARY OF ARGUMENT.

1. Section 125 of the Tax Statute authorizes the amortization of bond premium whether the bond be convertible or callable. This is clear from a consideration of the language of the statute, its legislative history and administrative interpretation.

2. The precise rules for determining the existence and amount of bond premium are unambiguously declared in Section 125 of the Tax Statute. Where the words of the statute are clear, unambiguous and unequivocal, it is the duty of the courts to enforce the congressional mandate.

3. To obtain a deduction a taxpayer need only point to an applicable statute and bring himself within its terms.

4. The phrases "bond premium" and "amortizable bond premium" must be interpreted according to their common usage. "Bond premium" is the amount by which the issue price or cost at a later date exceeds maturity value or, in the case a callable bond, earliest call date. The interest factor is not the sole or even the most important factor determining the existence or amount of bond premium; other factors such as (a) credit of the issuer, (b) security of the issue, (c) convertibility, (d) callability or redeemability and (e) redemption price, influence the situation. It is apparent from the record that the premium paid by the taxpayers on the American Telephone & Telegraph 3's, 1956, was not determined solely by the convertibility feature of the bond alone. It is also apparent from the record that Congress was not solely concerned with the amortization of bond premium attributable to the interest factor alone, nor did Congress

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establish any method or standard for segregating the various factors that influence bond premium. The idea that bond premium is solely influenced by the interest factor is a fiction.

5. This court has rejected the esoteric concept of the Commissioner that "interest" can be broken down into "true interest" and "bond premium." For the same reasons this court should reject the similar contention that "bond premium" can be dissected into "interest" and "true bond premium." (*Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 560, 52 S. Ct. 211, 76 L. Ed. 484, 489.)

6. The Tax Court inferred from the record that neither the interest rate nor the convertibility feature of the bonds in question was the sole determinant of the amount of bond premium. This finding being amply supported by the record, the Court of Appeals was not at liberty to draw a contrary inference. Where the decision of the Tax Court has warrant in the record and a reasonable basis in the law, its determination is final. (*Dobson v. Commissioner*, 320 U.S. 489, 501-2, 64 S. Ct. 239, 88 L. Ed. 248, 256.) The rule of *Dobson's* case is particularly applicable to problems of accounting. Moreover, the decisions of the Tax Court make for uniformity in the treatment of "amortizable bond premium," whereas the decision of the Court of Appeals for the 9th Circuit creates confusion and diversity, and will make for endless litigation with respect to each bond issue affecting each taxpayer.

7. The taxpayers have brought themselves squarely within the applicable provisions of Section 125 of the

Tax Statute. A taxpayer has the right to decrease the amount of his tax, by every lawful means. The deduction for amortization of bond premium allowed by Section 125 is not inconsistent with any other provisions of Section 23 of the Tax Statute. As in the case of depletion, Congress has established an arbitrary allowance determined by a statutory rule of thumb, based upon the impossibility of determining administratively for each taxpayer with respect to each bond issue the amount of bond premium attributable to interest alone. Since unpredictable and occasionally unjust and inequal results are likely to arise when a rule of thumb is applied without a detailed examination of the facts affecting each taxpayer, the claim that the result of the Tax Court's decision in this case is "garish" or "unreasonable" is without justification. (*Helvering v. Mountain Producers Corp.*, 303 U.S. 376, 381-2, 82 L. Ed. 907, 911, 58 S. Ct. 623.)

8. The decision of the Court of Appeals is a judicial attempt to remodel legislation and trespasses beyond the judicial and upon the legislative process.

II.

1. **STATUTORY AUTHORITY.—UNDER THE PROVISIONS OF THE INTERNAL REVENUE CODE, PETITIONERS ARE ENTITLED TO AMORTIZE OR DEDUCT PREMIUMS PAID BY THEM UPON THE CONVERTIBLE BONDS PURCHASED.**

The only duty upon a taxpayer seeking a deduction is that he must be able to point to an applicable statute and show that he comes within its terms.

White v. United States, 305 U.S. 281, 292, 59 S. Ct. 179, 83 L. Ed. 172, 179;

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New Colonial Ice Co. v. Helvering, 292 U.S. 435, 440, 54 S. Ct. 788, 78 L. Ed. 1348, 1352;

McDonald v. Commissioner, 323 U.S. 57, 60, 65 S. Ct. 96, 89 L. Ed. 68, 72, 155 A.L.R. 119;

Helvering v. Ohio Leather Co., 317 U.S. 102, 106, 63 S. Ct. 103, 87 L. Ed. 113, 119;

Herndon v. Commissioner (1949, 5th Cir.), 175 F. (2d) 55, 57;

Commissioner v. Riggs (3rd Cir.), 78 F. (2d) 1004, 1005.

The pertinent provisions of the Tax Statute and Regulations have been set out in full in the opinion of the Court of Appeals (R. 62-65), and in the Appendix hereto. It should be sufficient to direct attention to the particular provisions that are determinative of the issues in this case.

Section 125 (a) of the Tax Statute sets forth the General Rule to be applied, namely:

> "In the case of *any bond* as defined in subsection (d) the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941 * * *",

while subsection (d) of said section defines "bond" as

> "* * * *any bond,* debenture, note, or certificate or other evidence of indebtedness" etc. (Section 125 (d).)

There is expressly *excluded* from the definition of the term "bond"

> "* * * any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a

kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

It was stipulated in the Tax Court in the light of the foregoing provision that:

"17. The bonds purchased by petitioners, Joe Shoong and Rose Shoong, were not part of the stock in trade of the petitioners, or includible in any inventory of the petitioners at the close of the taxable years, or held by the petitioners primarily for sale to customers in the ordinary course of their trade or business. Petitioners did not, during the calendar year 1944, sell any of the bonds purchased by them, as aforesaid, nor did they exercise their privilege of converting said bonds into capital stock of the company." (R. 28, 29.)

The phrase, "any bond," etc. appearing in the first portion of Subdivisions (a) and (d), is all-inclusive and therefore includes callable and convertible bonds. The exclusion clause in the latter part of Subdivision (d) contains no express reference to callable or convertible bonds as such, and since particular expressions are limited in their qualification of general expressions, we urge that the general definition of the term "bond" in the first part of Subdivision (d) is expressly limited by the qualification appearing in the latter portion of said subdivision.

The duty rested upon Congress to determine the nature and extent of the qualification or exception to the term "bond", and since Congress did not include in the quali-

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fication or exception "callable or convertible bonds", that fact raises a conclusive presumption that Congress did not intend to make them such exception, and it is not the province of the Court to do so.

Wabash R. R. Co. v. U. S. (8th Cir.), 178 F. 5, 11;
U. S. v. Pan American etc. (9th Cir.), 55 F. (2d) 758, 772.

Since the latter portion of Subdivision (d) is designed to be an exception, the maxim, "*expressio unius est exclusio alterius,*" applies. It is a well settled principle of statutory construction that the expression of one thing excludes others not expressed.

Jones, Collector of Internal Revenue v. Crosswell (4th Cir.), 60 F. (2d) 827, at 828.

To extend the qualifying exception in the latter part of Subdivision (d) by including callable and convertible bonds would violate the cardinal rule of statutory construction which requires exceptions to be strictly construed.

Midland v. Ickes (8th Cir.), 125 F. (2d) 618, at 625-6.

In the interpretation of tax statutes it is the established rule *not* to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out and *in case of doubt, such statutes must be construed strictly in favor of the taxpayer.*

Gould v. Gould, 245 U.S. 151, 153, 38 S. Ct. 53, 62 L. Ed. 211, 213;

United States v. Merriam, 263 U.S. 179, 187, 44 S. Ct. 69, 68 L. Ed. 240, 244;

Hecht v. Malley, 265 U.S. 144, 44 S. Ct. 462, 68 L. Ed. 949, 957;

Hassett v. Welch, 303 U.S. 303, 314, 58 S. Ct. 559, 82 L. Ed. 858, 867;

Schwab v. Doyle, 258 U.S. 529, 536, 42 S. Ct. 391, 66 L. Ed. 747, 753;

Reinecke v. Northern Trust Co., 278 U.S. 339, 348, 49 S. Ct. 123, 73 L. Ed. 339, 348;

White v. Aronson, 302 U.S. 16, 20, 58 S. Ct. 95, 82 L. Ed. 20, 23.

The courts have held that a tax statute must be strictly construed in favor of the taxpayer and that it is not the prerogative of the courts, by judicial fiat, to read something into the statute that is not there.

Burns v. Commissioner (1949, 5th Cir.) 177 F. (2d) 739, 741.

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2. **LEGISLATIVE HISTORY.—THE RIGHT TO AMORTIZE OR DEDUCT THE AFOREMENTIONED PREMIUM RESTS NOT ONLY UPON THE LETTER OF THE CODE PROVISIONS, BUT ALSO UPON THE OBVIOUS INTENT OF THE BASIC STATUTE.**

Both the House and Senate Committee Reports in connection with the Revenue Act of 1942, which added Sections 23(v) and 125 to the Code, affirmatively set forth that:

> "*The fact that a bond is callable or convertible into stock does not of itself prevent the application of this section.* In the case of a callable bond, the earliest call date will, for the purposes of this section, be considered as the maturity date. Hence, the total premium is required to be spread over the period from the date

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as of which the basis of the bond is established down to the earliest call date, rather than down to the maturity date. *In the case of a convertible bond, if the option to convert the bond into stock rests with the owner of the bond, the bond is within the purview of this section.*" (Emphasis added.)

H. Rep. No. 2333, 77th Cong., 2d Sess., p. 80 (1942-2 CB 372, 433-434);

S. Rep. No. 1631, 77th Cong., 2d Sess., p. 94 (1942-2 CB 504, 576).

The language of the foregoing reports "is unequivocal and precisely includes the bonds in controversy." (*In re Korell*, Tax Court Opinion 10 T.C. 1001.)

There can be no doubt that the statute as finally enacted by the Congress incorporates the legislative intent as reflected by the House and Senate Committee Reports, all as expressed in the portions above quoted, by providing without equivocation that the rules prescribed by Section 125 apply not only to all bonds coming within the definition of the term as outlined in Subdivision (d), but as well apply in the case of "any bond" as outlined in Subdivision (a), including bonds convertible into stock.

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3. ADMINISTRATIVE INTERPRETATION.—THE STATUTORY RIGHT IS RECOGNIZED IN THE REGULATIONS ISSUED BY THE COMMISSIONER IN PURSUANCE OF THE CODE SECTION.

The Regulations issued in pursuance of the directions contained in Section 125 recognize the right to amortize bond premiums as was here done by the respective petitioners. Section 29.125-5 of Regulations 111 has a head-

ing reading as follows: "Callable and Convertible Bonds." The introductory sentence declares:

> "The fact that a bond is callable or convertible into stock does not, in itself, prevent the application of Section 125."

Later in the same section the following sentence appears:

> "A convertible bond is within the scope of Section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof."

There is no dispute that the bonds were convertible at the option of the holder at any date he chose, commencing with January 2, 1942, and ending with December 31, 1954.

The language of the Regulations 111, Section 29.125-5, is clearly unambiguous, and plain. Notwithstanding this fact, the Court of Appeals took a position completely at variance with the plain significance of the statute and the Regulations.

Of course, the Regulations seek to restrict the application of Section 125 in the case of convertible bonds to bonds conferring the privilege to convert "on a date certain," but this was characterized by the Tax Court in the *Korell* case as "a gratuitous addition" on the part of the Commissioner,

> "* * * not founded upon the statutory language and directly in conflict with its legislative history." *Commissioner v. Korell* (10 T.C. 1001).

The Court of Appeals in *Commissioner v. Korell*, held that irrespective of whether such language was gratui-

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tous or not, the statute contained no suggestion of the narrowing concept urged by the Commissioner.

We respectfully submit that callable and convertible bonds are within the purview of Section 125 for the reasons that (a) the statutory language includes "any bond", (b) the legislative history clearly indicates Congress intended that the holders of such bonds should have the benefit of that section, and (c) the Treasury regulations give administrative recognition and approval to such inclusion.

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4. SECTION 125 OF THE INTERNAL REVENUE CODE DECLARES UNAMBIGUOUSLY THE PRECISE RULES FOR THE DETERMINATION OF THE EXISTENCE OF BOND PREMIUM AND THE AMOUNT THEREOF.

In each of the notices of deficiency sent to the petitioners by the Commissioner the deductions claimed were disallowed in the following language:

> "The deduction is disallowed since it is held that the amount does not represent amortizable bond premium. *It is held that the consideration represents the value of the right to convert the bonds into capital stock of the company.*" (Emphasis ours.) (R. 9 and 18.)

In other words, the respondent claims and the Court of Appeals has held that the petitioners should be denied the right to amortize the premiums admittedly paid for the bonds because of the "conversion privilege acquired with the bonds." The answers to such contention have already been supplied in the earlier portions of this brief, and may be recapitulated as follows:

(a) Convertible bonds were not excluded from the definition of "bonds" under the Code.

(b) Both the Senate and House Committee Reports affirmatively disclose such bonds were intended to be included.

(c) The Regulations promulgated by the Commissioner specifically and clearly, state that convertible bonds are within the scope of the Code provisions.

The plain and unambiguous definition of "bond premium" as set forth in the Code must prevail even though the Court of Appeals held that (R. 69)

> "* * * Congress was solely concerned with the interest factor of the bonds * * *"

The simple language of the statute supplies the most forceful reply to the Court's ruling. Subdivision (b)(1) of Section 125 declares that the amount of the bond premium

> "* * * shall be determined with reference to the amount of the basis * * * of such bond and with reference to the amount payable on maturity or on earlier call date."

The word "basis" of course means "cost".

As stated in the Statement Of The Case, the bonds were subject to call at any time on or after September 1, 1942, and to and including August 31, 1953, on thirty days' notice of desire to exercise the right to redeem. Accordingly, the earliest call date with respect to any bonds purchased by the respondents in 1944 was thirty days from the purchase, and the bond premium therefore was to be amortized over the thirty day period.

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The simplicity of the language above quoted gave birth to equally simple language which the Commissioner placed in his Regulations 111 (Section 29.125-2) as follows:

> "Bond premium on any bond to which Section 125 applies *is* the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date." (Emphasis ours.)

What more is needed to clarify that which is already crystal clear, unless it be to put a polish upon the transparent surface of plain language. This function may be performed by a further excerpt from the Reports of the House Ways and Means Committee and the Senate Finance Committee, accompanying the Revenue Act of 1942, which reads:

> "*Bond premium, in the case of any bond subject to this section, IS the total premium thereon;* that is, the excess of the basis of the bond for determining loss over the amount payable at maturity. On the other hand, amortizable bond premium is such part of the total premium on the bond as is attributable to the taxable year." (Emphasis ours.)
>
> H. Rep. No. 2333, 77th Cong., 2d Sess., p. 79 (1942-2 CB 372, 432); S. Rep. No. 1631, 77th Cong., 2d Sess., p. 93 (1942-2 CB 504, 574-575).

In *Broadcasting etc. Inc. v. Federal Communications Commission* (Dist. of Col.), 171 F. (2d) 1007, 1010, the Court reaffirmed the principle that the most accurate guides for determining legislative intent and purpose

> "* * * are the words themselves which were enacted into law, provided those words are unambiguous and unequivocal"

and when language of a statute meets these tests it becomes

> "• • • not only the privilege but the duty of this court"

to interpret such statute accordingly.

In *Ex parte Collett*, 93 L. Ed. Adv. Op. 901, 903, the Court said

> "• • • there is no need to refer to the legislative history where the statutory language is clear. 'The plain words and meaning of a statute cannot be overcome by a legislative history, which through strained processes of deduction from events of wholly ambiguous significance, may furnish dubious bases for inference in every direction.' "
>
> *Gemsco, Inc. v. Walling*, 324 U.S. 244, 260, 89 L. Ed. 921, 933, 65 S. Ct. 605.

Where the language of a statute is clear and unambiguous, resort to legislative history or artificial canons of construction is unnecessary.

Packard Motor Car Co. v. N.L.R.B., 330 U.S. 485, 492, 67 S. Ct. 789, 91 L. Ed. 1040, 1050;

Brotherhood of R. Trainmen v. Baltimore & O. R. Co., 331 U.S. 519, 528, 529, 67 S. Ct. 1387, 91 L. Ed. 1646;

United States v. Rice, 327 U.S. 742, 753, 66 S. Ct. 835, 90 L. Ed. 982;

Guest v. Commissioner (1949, 5th Cir.), 175 F. (2d) 868, 869.

Where Congress has made a choice of language which fairly brings a given situation within a statute, it is un-

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important that the particular application may not have been contemplated by the Congress.

Barr v. United States, 324 U.S. 83, 65 S. Ct. 522, 89 L. Ed. 765, 771;

Puerto Rico v. Shell Co., 302 U.S. 253, 257, 58 S. Ct. 167, 82 L. Ed. 235, 240;

Browder v. United States, 312 U.S. 335, 339, 61 S. Ct. 599, 85 L. Ed. 862.

The Court of Appeals, in reaching its determination of congressional intent with respect to the construction of Section 125, seemingly was controlled and influenced by the circumstance that to allow amortization of bond premium in this particular case would be to the advantage of the taxpayers and would result in "a profitable stock investment". (R. 62.)

The determination of a substantive question is *not* to be controlled by whether in the particular case it is to the advantage of the Government or of the taxpayer.

Lewis v. Commissioner, 176 F. (2d) 646, 648 (1st Cir.).

The Court in *Portland Oil Co. v. Commissioner*, 109 F. (2d) 479, 488 (1st Cir.), very pointedly said:

> "Rather, the effort should be to seek out the true intendment of the law, let the chips fall how they may in the particular litigation. *Otherwise, to change the metaphor, interpretative chickens may come home to roost at a time when the barnyard wears quite a different aspect.*"

Mr. Justice Frankfurter's observation (in the dissenting opinion) in *Commissioner v. Wodehouse*, 93 L. Ed. Adv.

Op. 1043, 1062, is particularly applicable to the instant case.

> *"Instead, the Court appears to be guided, in however low a key that consideration is pitched, in construing the applicable provisions of the Internal Revenue Code by the urgent need for revenue. To let this need determine judicial construction of the Internal Revenue Code would largely dispense with explicitness and technical precision in revenue measures."*

The practical effect of the Court of Appeals' decision is to sweep all this aside, since it holds, in effect, that the amortizable bond premium refers only to the premium paid for a high interest rate and that the statute does not authorize the deduction of such premium if the bond has a convertible feature attached to it. There is no language in the tax statute which supports, either expressly or impliedly, the conclusion reached by the Court of Appeals.

The Court of Appeals states that while Section 125 provides for an "amortizable bond premium" yet "it does not purport to define that phrase." We see no justification for such statement by the Court of Appeals in the light of the language of Section 125 (b) with its three separate subdivisions and their significant headings. (Appendix.) This statement becomes even more amazing in the light of the attitude taken by the Commissioner which is reflected by the statement appearing in his petition for writ of certiorari in *Commissioner v. Korell*, wherein he states,

> "Section 23(v) merely included among the authorized deductions from gross income the allowance for 'amortizable bond premium' provided in Section 125.

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> *The latter section, in turn, defined 'amortizable bond premium,'* fixed the amount allowable in any taxable year, prescribed the method of determination of the amount deductible, and made other and detailed provisions with respect to the allowance."

It should require little citation of authority to support the well-known principle that the intention of Congress is to be sought for primarily in the language used, and where this expresses an intention reasonably intelligible and plain, it must be accepted without modification by resort to construction or conjecture.

Thompson v. U. S., 246 U. S. 547, 62 L. Ed. 876, 38 S. Ct. 349;

Caminetti v. U. S., 242 U. S. 470, 61 L. Ed. 442, 453, 37 S. Ct. 192;

In re Borchert (Cal.), 47 F. Supp. 387, 390;

Federal Savings & Loan Ins. Corp. v. Edison Savings & Loan Ass'n. (N. Y.), 83 F. Supp. 1007.

The Courts are not at liberty to construe language so plain as to need no construction, or to refer to committee reports where there can be no doubt of the meaning of the words used.

Helvering v. City Bank etc. Co., 296 U. S. 85, 80 L. Ed. 62, 66, 56 S. Ct. 70.

The Congressional intent must be controlling in the construction of federal statutes, *and it is only in the absence of an express or an implied intent that judicial construction may be resorted to.*

McKeown v. So. Cal. etc. Forwarder (Cal.), 52 F. Supp. 331, affirmed 148 F. (2d) 840; cert. denied, 326 U. S. 736, 90 L. Ed. 439, 66 S. Ct. 46; rehear-

ing denied, 326 U. S. 808, 90 L. Ed. 493, 66 S. Ct. 138.

See also:

Forrestal v. Commissioner (2d Cir.), 120 F. (2d) 223, 225;

Osaka etc. Line v. U. S., 300 U. S. 98, 81 L. Ed. 532, 57 S. Ct. 356.

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5. SINCE THE BOND PREMIUM AMORTIZED OR DEDUCTED BY PETITIONERS IS SQUARELY WITHIN THE PROVISIONS OF SECTIONS 23(v) AND 125 OF THE REVENUE CODE, THE APPELLATE COURT'S STATEMENT THAT DEDUCTIONS ARE MATTERS OF "LEGISLATIVE GRACE" AND "ARE TO BE STRICTLY CONSTRUED AGAINST THE TAXPAYER" ARE NOT APPLICABLE TO THIS CASE.

We have shown that under the specific provisions of the Internal Revenue Code, petitioners are authorized to amortize or deduct the premium paid by them for callable or convertible bonds.

Unquestionably Congress has the power to condition, limit or deny deductions (*Burnet v. Thompson Oil & Gas Co.*, 283 U. S. 301, 304, 51 S. Ct. 418, 75 L. Ed. 1049, 1052) but once having granted such deduction, the taxpayer has only to point to the applicable statute and show that he comes within its terms.

New Colonial Ice Co. v. Helvering, 292 U. S. 435, 440, 54 S. Ct. 788, 790, 78 L. Ed. 1348;

Commissioner v. Riggs (3rd Cir.), 78 F. (2d) 1004, 1005.

The deduction or amortization in this case, being plainly authorized by the provisions of the Internal Revenue

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Code, there is no need for construction, strict or otherwise and the statement of the Court of Appeals that deductions are matters of legislative grace and are to be strictly construed has no bearing.

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6. **THE COURT OF APPEALS ERRONEOUSLY ADOPTED THE COMMISSIONER'S STRAINED CONSTRUCTION OF THE STATUTORY LANGUAGE WITH RESPECT TO LIMITING THE AMORTIZABLE BOND PREMIUM TO THE INTEREST FACTOR ALONE.**

The Court of Appeals, asserting that it was relying upon House Report No. 2333, 77th Cong., 1st Session (Cum. Bull., 1942-2, 372, 410) held that the Congressional intent in creating the amortizable bond premium deduction referred solely to the interest provision of the bond and sought to support its holding by pointing out that since the word "interest" alone appears in the definition of a bond (Section 125 sub. (d)) the inference was that Congress was solely concerned with the amortization or deduction of premiums paid with respect to the interest factor of the bond only.

Since every bond is an evidence of indebtedness bearing interest, the Court of Appeals' conclusion based upon such definition is without merit. Moreover, assuming for purposes of argument only, that amortizable bond premium refers to the interest factor alone, then what is meant by "interest"?

Since Congress did not define the term "interest" the rule is that it used the word in its known and ordinary significance, which in this case was "what is usually called

interest by those who pay and those who receive the amount so denominated in bond and coupon." (*Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 560, 52 S. Ct. 211, 76 L. Ed. 484; *Consolidated Goldacres Co. v. Commissioner* (10th Cir.), 165 F. (2d) 542, 545).

Crane v. Commissioner, 331 U.S. 1, 6, 67 S. Ct. 1047, 91 L.Ed. 1301, 1306;

United States v. Wurts, 303 U.S. 414, 417, 58 S.Ct. 637, 639, 82 L.Ed. 932, 935;

Woolford Realty Co. v. Rose, 286 U.S. 319, 327, 52 S.Ct. 568, 570, 76 L.Ed. 1128, 1132;

Union Pac. R. Co. v. Hall, 91 U.S. 343, 347, 23 L.Ed. 428, 430;

United States v. Karnuth (W.D. N.Y.), 74 F. Supp. 660, 663.

In common understanding "bond premium" is "the amount by which the issue price or cost at a later date exceeds maturity value."[1] While the interest factor, namely the condition of the money market, is an element that influences bond premiums, it is not the sole or even the most important factor. It is well known that there are a number of other factors which determine bond premium such as (a) the credit standing of the issuing company, (b) the security of the bond issue, (c) whether such bond is convertible or redeemable, and if so, the time

[1]Advanced Accounting, W. A. Patton, The Macmillan Company, N. Y. 1941, pp. 196-7, 614.
American Business Practice, The Ronald Press Company, N. Y. 1931, p. 1653.
Accounting Principles, 4th Ed., Howard S. Noble, Southwestern Publishing Co., Cincinnati, Ohio, 1945, p. 447.

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element involved, and (d) the redemption price.[2] Since all these and, at times, other factors operate in the open market to determine bond premium, the Court of Appeals erred in holding that the term "amortizable bond premium" refers to only one of these factors, to-wit, the interest factor, to the exclusion of all others.

Contrary to the opinion of the Court of Appeals, the record discloses that the premium paid on any bond is not determined solely by the interest rate. The prices of *nonconvertible* bonds of Consolidated Edison of New York, Inc. and Pacific Gas & Electric Co. (Cal.) are shown in the Record (R. 26). The fluctuations in the prices of these bonds indicate that forces other than interest alone operating in the open market were determining the amount of premium required to be paid for each such bond. Were interest the sole factor, then the premiums would decrease with mathematical exactitude and regularity as the maturity or earlier call date of the bonds approached.

But the contrary appears from the Record (R. 26) when it is seen that Consolidated Edison of New York, Inc. debenture bonds (nonconvertible) *increased* in price, rather than decreased between April 30, 1943 and June 30, 1944, by approximately two points, although the maturity date was more than one year closer and presumably, according to the opinion of the Court of Appeals, a portion of the premium had been repaid to the bond holder and the market price of the bond should have been

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[2]Financial Handbook, 3rd Ed., Jules I. Bogen, The Ronald Press Company, N. Y. 1948, pp. 1210-11.
Basic Accounting Principles, Earl L. Saliers, Richard D. Irwin, Inc., Chicago, 1947, pp. 508-9.

less. The identical situation exists with respect to all bonds traded on the open market. The record also discloses that from July 30 to October 1, 1943, the market price of Consolidated Edison debenture bonds advanced from 105¾ to 108 while during the same period the market price of Pacific Gas & Electric bonds declined from 112⅞ to 110 (R. 26). Certainly these fluctuations in bond premium cannot be explained by the interest factor alone, especially in view of the fact that Standard & Poor's Monthly Bond Yield Index rose from July to October, 1943 only two thousandths of one percent (R. 27).

The foregoing refutes the Court of Appeals' position that the tax statute contemplates a necessary decrease in bond value by the mere passage of time, as a prerequisite to amortization (R. 68-9, 71). This misconception may be further illustrated by the hypothetical case of a non-convertible 4% bond selling at a premium when the average net yield of a comparable bond is 3%. Should the average net bond yield thereafter fall from 3% to 2%, then the bond premium at which the 4% bond could then be sold would increase by the mere passage of time, rather than decrease.

If, therefore, the Court of Appeals' opinion were to be sustained, any premium paid for such bond would not be amortizable. To state the proposition is to expose its fallacy. It follows, therefore, that the premium required to be paid on any bond purchased in the open market can *never* be attributed to the interest rate alone.

If the Court of Appeals be correct in its opinion that bond premium solely attributable to the interest factor is

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amortizable, then the deduction for amortizable bond premium enacted by Congress becomes meaningless.

The record discloses that when the petitioners purchased the bonds involved herein in June, 1944, the average yield on similar public utility bonds, as reflected in Standard and Poor's Monthly Bond Yield Index, was only 2.713% (R. 27). According to the position adopted by the Court of Appeals, to the extent, at least, that 3% exceeds 2.713%, a premium resulting from interest was paid by the taxpayers. Therefore, the statement by the Court that "the amount of interest played *no part* in determining their purchase price above par," (R. 68) is not only without support, but actually contrary to the stipulated facts of the case.

The statute does not authorize nor do the regulations require that the factors which determine bond premium must be segregated, either by the taxpayer or the Commissioner, nor is there any formula or procedure for making such segregation or determination of that portion of the total bond premium which shall be allocated to each of the foregoing factors or any other factors which may be present.

The fact that the amount of bond premium actually attributable to interest as distinguished from other factors cannot be determined except upon theoretic considerations of "average bond yield", and financial indices, which Congress did *not* adopt as a standard, emphasizes Congressional wisdom in not attempting to define "amortizable bond premium" in terms of interest or net yield.

Moreover, the Commissioner's concept of bond premium, adopted by the Court of Appeals in its decision, namely, that bond premium represents the excess capital paid solely to obtain a higher rate of interest, is not as pointed out by the Court of Appeals on rehearing in the *Korell* case, such a legal or lay mandate as appealed to the several members of the Tax Court or to the members of the Court of the Second Circuit.

"That the premium is paid solely in respect of interest, which is the assumption supporting the amortization, is a *fiction*, is demonstrated by any survey of bond prices," is pointed out in 45 Yale L.J. 156, 158, discussing *Old Colony Trust Co. v. Comstock*, 290 Mass. 377, 195 N.E. 389, 101 A.L.R. 1.

The Court of Appeals in the *Korell* case, on rehearing, pointedly said:

> "Indeed, from the time of Holmes on, the idea that the premium is paid solely for interest above the market rate has been attacked as clearly a *fiction*. *Hemenway v. Hemenway*, 134 Mass. 446, 449; *New England Trust Co. v. Eaton*, 140 Mass. 532, 544, 545, 4 N.E. 69, 77, 78, 34 Am. Rep. 493; 45 *Yale L.J.* 156; 20 *Minn. L. Rev.* 203; 34 *Mich. L. Rev.* 448." (Italics ours.)

The Court of Appeals, in *Commissioner v. Korell*, explicitly refused to adopt the assumption that the "premium" to which the statute refers is solely the amount paid for a high interest rate and labeled any such idea a fiction.

In fact the Court of Appeals in *Commissioner v. Korell* pointed out that the Commissioner's restricted meaning of

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"premium" has been definitely rejected in the law of trusts and in the apportionment of principal and income to life tenant and remainderman where the general idea of amortization has had its most extensive development in the law. The Court in this connection said:

> "Thus where amortization is required, a trustee is expected to restore to principal the excess amount he has expended, *not some lesser theoretic amount resting on an unknown variable such as the assumed normal rate of interest on money.* 1 Restatement, Trusts, sec. 239, comment f, 1935; 2 Scott on Trusts, sec. 239.2, 1939; 4 Bogert on Trusts and Trustees, sec. 831, 1935." (Emphasis added.)

We respectfully submit that in adopting the Commissioner's fictional theory of "bond premium" predicated upon the interest factor alone, the Court of Appeals in this case erred.

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7. THE COURT OF APPEALS ERRONEOUSLY ADOPTED THE COMMISSIONER'S ESOTERIC CONCEPT OF "TRUE BOND PREMIUM" WHICH HAS BEEN PREVIOUSLY REJECTED BY THIS COURT.

The Court of Appeals adopted the Commissioner's contention, namely, that the proper procedure was to amortize not the excess of the basis of the bond for determining loss over the amount payable at maturity or earlier call date, which is commonly called bond premium (H. Rep. No. 2333, 77th Cong., 2d Sess., p. 79 (1942-2 CB 372, 432); S. Rep. No. 1631, 77th Cong., 2d Sess., p. 93 (1942-2 CB 504, 574-575), but a different sum to be ascertained by an undisclosed and abstruse calculation which is sup-

posed to allocate the bond premium between the convertible feature of the bond and the Commissioner's concept of "true bond premium," to-wit, the difference between the yield and the actual interest rate.

However, this Court in *Old Colony R. Co. v. Commissioner*, 284 U.S. 552, 560, 52 S. Ct. 211, 76 L. Ed. 484, 489, refused to adopt such "esoteric concept derived from subtle and theoretic analysis" when the Commissioner similarly contended that a taxpayer could not deduct from his gross income the amount agreed to be paid as interest, but only a different sum calculated so as to allocate the payment of interest between "effective" or "true interest" and a partial or ratable return of "true bond premium."

This Court held in the *Old Colony* case that the term "interest" could not be broken down into two components, to-wit, "true interest" and "bond premium." It follows, therefore, that the term "bond premium" cannot be separated into two components, to-wit, "interest" and "true bond premium." There is, consequently, no basis for placing the strained construction upon the statute or for subjecting the term "amortizable bond premium" to subtle and theoretic analysis.

Deputy v. du Pont, 308 U.S. 488, 498, 84 L. Ed. 416, 424, 60 S. Ct. 363;

Commissioner v. Columbia River P. Mills (9th Cir.), 126 F. (2d) 1009, 1010;

Commissioner v. Proctor Shops, Inc. (9th Cir.), 82 F. (2d) 792;

Commissioner v. T. R. Miller Mill Co. (5th Cir.), 102 F. (2d) 599.

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8. THE TAX COURT HAVING HELD THAT THE AMOUNT ABOVE PAR PAID FOR THE BONDS WAS BOND PREMIUM THE COURT OF APPEALS WAS NOT AT LIBERTY TO DRAW A CONTRARY INFERENCE THAT SUCH AMOUNT WAS PAID SOLELY FOR A STOCK PURCHASING COVENANT.

The holding of the Tax Court was that the amount above par paid by the taxpayer was a bond premium. Therefore, the Court of Appeals was not permitted to draw a contrary inference, to-wit, that the amount above par paid for the bonds was paid solely for the stock purchasing covenant.

The initial function of drawing inferences is for the Tax Court, rather than for the Court of Appeals on petition for review, even from stipulated facts.

Raffold Process Corp. v. Commissioner (1st Cir.), 153 F. (2d) 168;

Boehm v. Commissioner, 326 U.S. 287, 294, 66 S.Ct. 120, 90 L.Ed. 78, 84.

If opposing inferences reasonably may be drawn from undisputed facts, the judgment of the Tax Court as to what inferences shall be drawn is controlling.

Tyson v. Commissioner (8th Cir.), 146 F. (2d) 50;

Jones v. Commissioner (9th Cir.), 103 F. (2d) 681;

Elmhurst Cemetery Co. v. Commissioner, 300 U.S. 37, 40, 57 S.Ct. 324, 81 L.Ed. 491.

Great weight and consideration should be accorded to decisions of the Tax Court.

Commissioner v. Midland Elec. Coal Corp. (7th Cir.), 152 F. (2d) 171;

Hall v. Commissioner (10th Cir.), 150 F. (2d) 304;

Barnhill v. Commissioner (4th Cir.), 148 F. (2d) 913;

Armstrong v. Commissioner (10th Cir.), 143 F. (2d) 700, 701.

Where the decision of the Tax Court has "warrant in the record" and "a reasonable basis in the law" its administrative determination is final. As stated in the leading the case of *Dobson v. Commissioner*, 320 U.S. 489, 501-2, 64 S.Ct. 239, 88 L.Ed. 248, 256:

> "But 'the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body.'" (citing cases.)
>
> "Congress has invested the Tax Court with the primary authority for redetermining deficiencies, which constitutes the greater part of tax litigation. This requires it to consider both the law and facts. Whatever latitude exists in resolving questions *such as those of proper accounting* * * * *exists in the Tax Court and not in the regular courts* * * *" (Emphasis added.)

To the same effect are:

Commissioner v. Sunnen, 333 U.S. 591, 607, 92 L.Ed. 898, 911, 68 S.Ct. 715;

Commissioner v. Rainier Brewing Co. (1948, 9th Cir.), 166 F. (2d) 324, 325;

Southern Pac. Co. v. Joint Council Dining Car Employees (1947, 9th Cir.), 165 F. (2d) 26, 30;

Chertoff v. Commissioner (1947, 6th Cir.), 160 F. (2d) 691, 695-6;

Fleischer v. Commissioner (1946, 8th Cir.), 158 F. (2d) 42, 43.

The question of *amortization* is solely a question of proper accounting, and therefore falls directly within the

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operation of the rule in *Dobson's* case. In this field, the decision of the Tax Court must be accepted by the Courts of Appeal, particularly where the decisions of the Tax Court make for uniformity, and where the decisions of the Courts of Appeal have only created confusion and diversity (R. 71).

Carlisle Tire & Rubber Co. v. Commissioner (1948, 3rd Cir.), 168 F. (2d) 816, 818-9.

It does not seem likely that the Tax Court consisting of sixteen members, one member of which wrote a "carefully reasoned opinion," which was reviewed "by the whole Court" *without any dissent*, would render a decision without a rational basis therefor. These sixteen experienced judges of the Tax Court found that the taxpayer's conduct in both the *Shoong* and *Korell* cases was in conformity with law and rendered judgment in their favor accordingly. Three experienced judges of the Court of Appeals for the Second Circuit found no error in the judgment by the Tax Court that was rendered for the taxpayer, Korell. In contrast to the unanimity of the Tax Court are the divergent opinions of the Courts of Appeals for the 2nd and 9th Circuits. The division in the Courts of Appeal underlines the fact that nineteen judges, sixteen of whom were members of the Tax Court and three of whom were members of the Court of Appeals for the Second Circuit, could not unreasonably have entertained the views they did. We respectfully submit that this is the very type of situation where the courts have been instructed "to follow the 'hands off' policy with regard to results reached by the Tax Court."

Commissioner v. Henry's Estate, 161 F. (2d) 574, 578 (3rd Cir.).

This case deals not only with accounting methods, but with well understood words such as interest and bond premium. The Tax Court is particularly fitted to decide whether the deduction taken by taxpayers amounted to amortizable bond premium.

John Kelley Co. v. Commissioner, 326 U.S. 521, 530, 90 L. Ed. 278, 283, 66 S. Ct. 299.

For all of the foregoing reasons we respectfully urge that the decision of the Court of Appeals should be reversed, and the decision of the Tax Court affirmed.

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9. THE AMOUNT OF THE BOND PREMIUM AMORTIZED BY EACH OF THE PETITIONERS RESPECTIVELY SHOWS SUBSTANTIAL IF NOT EXACT COMPLIANCE WITH THE TERMS OF SECTION 125 OF THE CODE, AND IS THEREFORE FULLY DEDUCTIBLE UNDER SECTION 23 (v) THEREOF.

The Stipulation of Facts in this case (R. 20) makes manifest that the petitioners have complied with all statutory requirements, which compliance may be epitomized as follows:

(1) Subsection (a)(1) of Section 125 requires that bond interest be fully taxable.

Interest on the bonds was fully taxable, and the requirement of this subsection was therefore fulfilled.

(2) Subsection (b)(1) requires that in determining the bond premium the holder of "any bond" must use the basis "(for determining loss on sale or exchange)" of such bond and the amount payable at the maturity or earlier call date.

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Fulfilling this requirement, (a) Joe Shoong used the difference between the purchase price of $601,879.94 (his basis for determining loss) and the earliest call date price of $520,000.00 as the bond premium, thus leaving the balance of $81,879.94 for amortization, and (b) Rose Shoong used the difference between the purchase price of $605,607.29 (her basis for determining loss) and the earliest call date price of $520,000.00 as the bond premium, thus leaving the balance of $85,607.29 for amortization.

(3) Subsection (b)(2) defines "amortizable bond premium" as the "amount of the bond premium attributable to such year," meaning the taxable year.

Each of the petitioners purchased all of his or her bonds in 1944, and the earliest call date was in 1944. It follows, therefore, that the entire premium was amortizable in conformity with the foregoing provision in the taxable year 1944.

(4) Subsection (b)(3) provides that one method of computing amortizable bond premium in addition to the method which may be employed by the holder of the bond, was such method which may be prescribed by the Commissioner.

Each of the petitioners followed precisely the method prescribed by the Commissioner in Regulations 111, Section 29.125-5.

(5) Subsection (c)(2) directs that if the taxpayer makes an election with respect to any bond,

> "* * * it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies."

The petitioners purchased in 1944 the bonds in question and sought to amortize the bond premium on "all such bonds."

(6) Subsection (d) was designed to deny to security dealers and traders the opportunity of computing bond premium amortization under Section 125 on bonds held as "stock in trade" primarily for sale to customers in the ordinary course of trade or business.

It was stipulated as to each of the petitioners under Paragraph 17 of the Stipulation of Facts (R. 28) that neither of the petitioners was a security dealer or trader.

The Court of Appeals neither found nor held that the transactions were illegal on the ground that they were entered into for tax saving purposes or that by virtue thereof the taxpayers should be denied the right of amortizing the bond premium. The tax statute does not prohibit such transactions.

Under these circumstances, it has been held that the right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.

Sampson Tire etc. Corp. v. Rogan (9th Cir.), 136 F. (2d) 345, 347;

Commissioner v. Eldridge (9th Cir.), 79 F. (2d) 629, 631;

National Carbide v. Commissioner, 93 L. Ed. Adv. Op. 634, affirming *Commissioner v. National Carbide*, 167 F. (2d) 304, 307 (2nd Cir.);

Gregory v. Helvering, 293 U.S. 465, 469, 55 S. Ct. 266, 79 L. Ed. 596;

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Superior Oil Co. v. Mississippi, 280 U.S. 390, 395, 50 S. Ct. 169, 74 L. Ed. 504;
Murchie v. Delaney, 82 F. Supp. 176 (Mass.);
Bowman v. Glenn, 84 F. Supp. 200, 202 (Ky.).

All other facts to which the Court of Appeals makes reference are immaterial to the issues of this case. The petitioners contend that the primary question is one of statutory construction, as was admitted by the Commissioner, and it therefore becomes immaterial whether the bond premium is a "true bond premium" or not, with the Commissioner setting himself up as the one to determine what is true and what is not true.

Nor is the deduction for amortizable bond premium inconsistent with any of the provisions of section 23 of the Tax Statute. Admittedly, deductions are a matter of legislative grace and are permitted by Congress irrespective of the fact of actual loss. For example, subdivision (aa) of section 23 provides for an optional standard deduction of up to $1,000 *regardless* of whether the taxpayer has suffered any deductible loss or made any charitable contribution; subdivision (n) authorizes deductions for depreciation and depletion of capital assets even though, in the case of depreciation, there may have been an actual increase in the market value of the property concerned, and in the case of depletion the statutory allowance may be larger or smaller than is actually the fact.

The provisions of section 114 of the Tax Statute with respect to depletion bear a striking analogy to the provisions of section 125 relating to amortization of bond premium. In both of the sections referred to, Congress has

authorized a statutory deduction which is determined from the terms of the statute by an arbitrary rule of thumb, based upon a realistic approach by Congress and the realization that in fairness to the taxpayer there should be an allowance for the exhaustion of mineral deposits in the course of production in the one case, and for the diminution of bond premium as maturity or earlier call date approaches, in the other.

To determine the actual extent of depletion as well as the diminution of bond premium on the particular facts in relation to each taxpayer, would give rise to problems of considerable perplexity and would create administrative difficulties which Congress intended to overcome by laying down "a rule of thumb" which could be easily applied. This Court, in discussing the arbitrary allowance for depletion in Sections 23 (m) and 114 of the Tax Statute has said:

> "Congress was free to give such an arbitrary allowance, as the deduction was an act of grace. In answer to the contention that the provisions may produce 'unjust and unequal results', we have remarked that this is likely to be so 'whenever a rule of thumb is applied without a detailed examination of the facts affecting each taxpayer.'" (Citing cases.)
>
> "The rule being of this sort for obvious purposes of administrative convenience, we must apply it in the simple manner it contemplates."
>
> *Helvering v. Mountain Producers Corp.*, 303 U. S. 376, 381-2, 82 L. Ed. 907, 911, 58 S. Ct. 623.

To the same effect are:

> *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 321, 79 L. Ed. 383, 389, 55 S. Ct. 174;

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Commissioner v. O'Shaughnessy, Inc. (10th Cir.), 124 F. (2d) 33, 37;

Commissioner v. Kirby Petroleum Co. (5th Cir.), 148 F. (2d) 80, 83.

Statutory amortization of bond premium is likewise "a rule of thumb", to meet a special case. Section 125(b) of the Tax Statute sets forth a simple rule for computing the amount of amortizable bond premium, and recognizes implicitly the impossibility of administrative determining on the particular facts of each bond issue in relation to each taxpayer the various factors which influenced the amount of bond premium he paid, and the variable weight that must be given to each such factor.

To characterize the result of the Tax Court's decision as "unreasonable" or "garish" is to ignore the "arbitrary allowance" established by Congressional grace. Moreover, the Court of Appeals, in its decision overlooked the fact that when the taxpayers in this case amortized the amount of the bond premium in accordance with the provisions of section 125, they were required to adjust the basis of such bonds for determining loss or gain in accordance with the provisions of section 113(b)(1)(B) of the Tax Act, which expressly treats "amortization and depletion" in the same fashion. Therefore, when in 1945, Joe Shoong sold $500,000 face value American Telephone and Telegraph bonds for $615,799.98 which cost him in 1944, $601,879.94, he actually reported a capital gain of $95,799.98 (on an adjusted basis) instead of $13,920.04 (on the basis of cost), and paid a tax on the larger amount. Likewise, when in 1945 Rose Shoong sold the bonds in question for $615,000.16, which cost her in 1944, $605,-

607.29, she actually reported a capital gain of $95,000.16 (on an adjusted basis) instead of $9,392.87 (on the basis of cost), and thus paid a tax on the greater amount. (R. 29.)

There is certainly nothing "garish" or "unreasonable" in taking advantage of the 50% differential applied to long term capital gains under the express provisions of section 117(b) of the Tax Statute. The income tax laws are *not* evaded when a taxpayer makes his purchases and sales of securities with the existence and application of prevailing tax laws in mind. It is common knowledge that all who pay income taxes do much figuring and conduct their business, either large or small, on a basis that will call for the least amount of income tax payments.

Morton v. Commissioner (7th Cir.), 109 F. (2d) 47, 51.

In *U. S. v. Cumberland Pub. Serv. Co.* (No. 214—October Term, 1949; decided January 9, 1950) this Court, speaking through Mr. Justice Black, declared that a primary motive to avoid the burden of taxation is immaterial so long as there is statutory authority for the taxpayer's conduct. In commenting upon the claim that the result of the Court's decision in favor of the taxpayer was "odd", the Court said:

> "The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern . . . .
>
> "Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate."

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As indicated, Congress undertook to determine by statute what was to be regarded as an "amortizable bond premium", and so long as Congress spoke clearly, it is not the function of either the Commissioner or the Court to enlarge upon Congressional language, by a standard which is personal to the Commissioner and not even suggested in his Regulations, or which may be personal to the individual members of a specific circuit of a Court of Appeals.

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10. THE DECISION OF THE COURT OF APPEALS IS A JUDICIAL ATTEMPT TO REMODEL LEGISLATION AND TRESPASSES BEYOND THE JUDICIAL AND UPON THE LEGISLATIVE PROCESS.

The Court of Appeals in *Commissioner v. Korell* pointedly observed that to avoid the result complained of by the Commissioner would involve "a judicial attempt to remodel legislation" and to make the distinctions urged by the Commissioner would be "trespassing beyond the judicial, and upon the legislative process."

It is the duty of a court to apply a tax statute as it finds it, leaving to Congress the correction of asserted inconsistencies and inequalities in its operation.

McClain v. Commissioner, 311 U. S. 527, 530, 85 L. Ed. 319, 322, 61 S. Ct. 375;

Stokes v. Commissioner (3rd Cir.), 124 F. (2d) 335, 339;

Commissioner v. Caulkins (6th Cir.), 144 F. (2d) 482, 484.

It is not a court's function to engraft upon a statute additions which it thinks the legislature might or should have made.

United States v. Cooper Corp., 312 U. S. 600, 605, 85 L. Ed. 1071, 1076, 61 S. Ct. 742;

Forstmann v. Rogers (3rd Cir.), 128 F. (2d) 126, 129;

Iselin v. United States, 270 U. S. 245, 250-1, 70 L. Ed. 566, 569-70, 46 S. Ct. 248.

Where the words of a statute are plain, a court is not at liberty to add to or alter them to effect a purpose which does not appear on its face or which varies from its legislative history.

Matson Navigation Co. v. United States, 284 U. S. 352, 356, 76 L. Ed. 336, 340, 52 S. Ct. 152;

Corona Coal Co. v. United States, 263 U. S. 537, 540, 68 L. Ed. 431, 433, 44 S. Ct. 156.

The courts have no function of legislation, but must simply seek to ascertain the will of the legislature and give effect to plain congressional intent manifested in statutes.

United States v. Goldenberg, 168 U. S. 95, 103, 18 S. Ct. 3, 4, 42 L. Ed. 394;

Ebert v. Poston, 266 U. S. 548, 45 S. Ct. 188, 190, 69 L. Ed. 435, 438;

Koster v. Turchi (3rd Cir.), 173 F. (2d) 605, 607.

To permit the decision in this case to become law, is to put the stamp of approval on judicial remodeling of legislation and the invasion of the judicial upon the legislative process.

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III.

CONCLUSION.

It is respectfully submitted that the Tax Court in this case and the Court of Appeals in *Commissioner v. Korell,* interpreted the statute and the Regulations correctly and that the decision of the Court of Appeals in this case should be reversed.

Dated, San Francisco, California,
January 30, 1950.

Respectfully submitted,
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(Appendix Follows.)

Appendix

U. S. C. A., Title 26, Internal Revenue Code:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

• • • • • • •

(n) *Basis For Depreciation and Depletion.* The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

• • • • • • •

(v) *Bond Premium Deduction.* In the case of a bondholder, the deduction for amortizable bond premium provided in section 125.

• • • • • • •

(aa) *Optional Standard Deduction For Individuals.*

(1) *Allowance.* In the case of an individual, at his election a standard deduction as follows:

(A) *Adjusted Gross Income $5,000 or More.* If his adjusted gross income is $5,000 or more, the standard deduction shall be $1,000 or an amount equal to 10 per centum of the adjusted gross income, whichever is the lesser, except that in the case of a separate return by a married individual, the standard deduction shall be $500.

• • • • • • •

Sec. 113. Adjusted Basis for Determining Gain or Loss.

• • • • • • •

(b) *Adjusted Basis.* The adjusted basis for determining the gain or loss from the sale or other disposition

of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1) *General Rule.* Proper adjustment in respect of the property shall in all cases be made—

• • • • • • •

(B) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this chapter or prior income tax laws. • • •

• • • • • • •

Sec. 114. Basis for Depreciation and Depletion.

(a) *Basis for Depreciation.* The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) *Basis for Depletion.*

(1) *General Rule.* The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

• • • • • • •

Sec. 117. Capital Gains and Losses.

• • • • • • •

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(b) *Percentage Taken Into Account.* In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

• • • • • • •

Sec. 125. AMORTIZABLE BOND PREMIUM.

(a) *General Rule.* In the case of any bond, as defined in subsection (d), the following rules shall apply to the amortizable bond premium (determined under subsection (b)) on the bond for any taxable year beginning after December 31, 1941:

(1) *Interest wholly or partially taxable.* In the case of a bond (other than a bond the interest on which is excludible from gross income), the amount of the amortizable bond premium for the taxable year shall be allowed as a deduction.

(2) *Interest wholly tax-exempt.* In the case of any bond the interest on which is excludible from gross income, no deduction shall be allowed for the amortizable bond premium for the taxable year.

(3) *Adjustment of Credit in case of interest partially tax-exempt.* In the case of any bond the interest on which is allowable as a credit against net income, the

credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, shall be reduced by the amount of the amortizable bond premium for the taxable year.

(For adjustment to basis on acconut of amortizable bond premium, see section 113(b) (1) (H)).

(b) *Amortizable bond premium.*

(1) *Amount of bond premium.* For the purposes of paragraph (2), the amount of bond premium, in the case of the holder of any bond, shall be determined with reference to the amount of the basis (for determining loss on sale or exchange) of such bond, and with reference to the amount payable on maturity or on earlier call date, with adjustments proper to reflect unamortized bond premium with respect to the bond, for the period prior to the date as of which subsection (a) becomes applicable with respect to the taxpayer with respect to such bond.

(2) *Amount Amortizable.* The amortizable bond premium of the taxable year shall be the amount of the bond premium attributable to such year.

(3) *Method of determination.* The determinations required under paragraphs (1) and (2) shall be made—

(A) in accordance with the method of amortizing bond premium regularly employed by the holder of the bond, if such method is reasonable;

(B) in all other cases, in accordance with regulations prescribing reasonable methods of amortizing bond premium, prescribed by the Commissioner with the approval of the Secretary.

(c) *Election on taxable and partially taxable bonds.*

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(1) *Eligibility to elect and bonds with respect to which election permitted.* This section shall apply with respect to the following classes of taxpayers with respect to the following classes of bonds only if the taxpayer has elected to have this section apply.

(A) *Partially tax-exempt.* In the case of a taxpayer other than a corporation, bonds with respect to the interest on which the credit provided in section 25(a) (1) or (2) is allowable; and

(B) *Wholly taxable.* In the case of any taxpayer, bonds the interest on which is not excludible from gross income but with respect to which the credit provided in section 25(a) (1) or (2), or section 26(a), as the case may be, is not allowable.

(2) *Manner and effect of election.* The election authorized under this subsection shall be made in accordance with such regulations as the Commissioner with the approval of the Secretary shall prescribe. If such election is made with respect to any bond (described in paragraph (1)) of the taxpayer, it shall also apply to all such bonds held by the taxpayer at the beginning of the first taxable year to which the election applies and to all such bonds thereafter acquired by him and shall be binding for all subsequent taxable years with respect to all such bonds of the taxpayer, unless, upon application by the taxpayer, the Commissioner permits him, subject to such conditions as the Commissioner deems necessary, to revoke such election. The election authorized under this subsection in the case of a member of a partnership shall be exercisable with respect to bonds of the partnership only by the

partnership. In the case of bonds held by a common trust fund, as defined in section 169, or by a foreign personal holding company, as defined in section 331, the election authorized under this subsection shall be exercisable with respect to such bonds only by the common trust fund or foreign personal holding company.

(d) *Definition of bond.* As used in this section, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Added Oct. 21, 1942, 4:30 p.m., E.W.T., c. 619, title I, sec. 126(b), 56 Stat. 822.

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.125-1. In General.—(a) *Application.*—Section 125 makes provision for the amortization of bond premium by the owners of the bonds. It is mandatory with respect to—

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It is optional, at the election of the taxpayer, with respect to—

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(1) fully taxable bonds (the interest on which is subject to normal tax and surtax), whether the owner is a corporation, individual, or other taxpayer; and

(2) partially tax-exempt bonds owned by taxpayers other than corporations.

The term "bond" as used in section 125 means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation and bearing interest (including any like obligation issued by a government or political subdivision thereof), with interest coupons or in registered form, but does not include any such obligation which constitutes stock in trade of the taxpayer or any such obligation of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or any such obligation held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. Since bonds owned by dealers in securities are excluded from the foregoing definition, section 125 has no application to such dealers.

(b) *Operation.*—In the case of a fully tax-exempt bond, the amortizable bond premium for the taxable year is simply an adjustment to the basis or adjusted basis of the bonds. Thus, if such premium is $1, the basis or adjusted basis of the bond is reduced by $1. No deduction is allowable on account of such amortizable bond premium. In the case of a fully taxable bond to which section 125 is applicable, the amortizable bond premium is both an adjustment to the basis or adjusted basis of the bond and a deduction.

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Sec. 29.125-2. *Bond Premium and Amortizable Bond Premium.*—Bond premium on any bond to which section 125 applies is the excess of the amount of the basis (for determining loss on sale or exchange) of the bond over the amount payable at maturity or, in the case of a callable bond, earlier call date. (For determination of applicable call date see section 29.125-5.) If the date as of which such basis of the bond was established precedes the first taxable year with respect to which such section applies to the bond, there shall be made adjustments proper to reflect unamortized bond premium on such bond for the period including the holding period (as determined under section 117 (h)) prior to the date as of which section 125 first becomes applicable to the bond in the hands of the taxpayer.

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Amortizable bond premium on any bond to which section 125 applies is such part of the bond premium on the bond as is attributable to the taxable year.

Sec. 29.125-3. *Methods of Amortization.*—The determinations of the bond premium and amortizable bond premium on any bond to which section 125 applies shall be made in accordance with:

(a) the method of amortization regularly employed by the taxpayer, if such method is reasonable; or

(b) the method of amortization prescribed by this section.

A method of amortization will be deemed "regularly employed" by a taxpayer if the method was consistently followed in taxable years beginning prior to

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January 1, 1942, or if for taxable years beginning on or after such date the taxpayer (including a taxpayer who followed a different method in taxable years beginning prior to January 1, 1942) initiates in the first taxable year for which the deduction is taken a reasonable method of amortization and consistently follows such method thereafter. A taxpayer who regularly employs a method of amortization may be one, for example, who is subject to the jurisdiction of a State or Federal regulatory agency and who, for the purposes of such agency, amortizes the bond premium on his bonds in accordance with a method prescribed or approved by such agency. However, it is not necessary that the taxpayer be subject to the jurisdiction of such an agency or that the method be prescribed or approved by such agency. It is sufficient if the taxpayer regularly employs a method of amortization and if such method is reasonable.

The method of amortization prescribed by this section is as follows:

(1) The bond premium on any bond to which section 125 applies shall be determined in accordance with section 29.125-2 and shall be computed as of the end of the taxable year (or as of the date of disposition or redemption of the bond, if it was disposed of or redeemed in the taxable year) but without regard to the amortizable bond premium for the taxable year; and

(2) The amortizable bond premium on such bond for the taxable year shall be an amount which bears the same ratio to the bond premium on the bond as the number of months in the taxable year during which the bond was owned by the taxpayer bears to the number of months

from the beginning of the taxable year (or, if the bond was acquired in the taxable year, from the date of acquisition) to the date of maturity or earlier call date. For the purposes of this section a fractional part of a month shall be disregarded unless it amounts to more than half a month in which case it shall be considered as a month.

Sec. 29.125-4. *Election.*—In the case of a corporation, the election provided in section 125 may be made only with respect to fully taxable bonds. In the case of a taxpayer other than a corporation, the election provided in such section may be made with respect to (a) fully taxable bonds only, or (b) partially tax-exempt bonds only, or (c) both fully taxable bonds and partially tax-exempt bonds. Such election shall be made by the taxpayer by claiming a deduction for the bond premium in his return for the first taxable year to which he desires the election to be applicable. No other method of making such election is permitted. If the election is so made, the taxpayer should attach to his return a statement showing the computation of the deduction. The election shall apply to all bonds in respect of which it was made owned by the taxpayer at the beginning of the first taxable year to which the election applies and also to all bonds of such class (or classes) thereafter acquired by him, and shall be binding for all subsequent taxable years. Upon application by the taxpayer, the Commissioner may permit him to revoke the election, subject to such conditions as the Commissioner deems necessary. * * *

Sec. 29.125-5. *Callable and Convertible Bonds.*—The fact that a bond is callable or convertible into stock does not in itself, prevent the application of section 125. For

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the purpose of such section, in the case of a callable bond the earlier call date will be considered as the maturity date and the amount due on such date will be considered as the amount payable on maturity, unless the taxpayer regularly employs a different method of amortization which is reasonable. Hence, the bond premium on such a bond is required to be spread over the period from the date as of which the basis for loss of the bond is established down to the earlier call date, rather than the maturity date. The earlier call date may be the earliest call date specified in the bond as a day certain, the earliest interest payment date if the bond is callable at such date, the earliest date at which the bond is callable at par, or such other call date, prior to maturity, specified in the bond as may be selected by the taxpayer. A taxpayer who deducts amortizable bond premium with reference to a particular call date may not thereafter use a different call date in the calculation of amortization deductions with respect to such premium. A convertible bond is within the scope of section 125 if the option to convert on a date certain specified in the bond rests with the holder thereof.